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ABSTRACT

This booklet offers guidelines for college and university trustees for managing the institution's endowment funds as they seek to balance efforts to grow the endowment for the institution's future with the need to use these funds to supplement current budget needs. Critical policy issues are identified, such as: the endowment's purpose, maximizing return on assets, contribution of endowment funds to operating budgets, whether to spend or preserve endowment funds, whether the entire board or an investment committee makes investment decisions, and monitoring and evaluating the performance of professional investment managers. Since the board's most basic responsibility is preserving institutional resources, including the endowment, in perpetuity, investment objectives should result in total returns equal to or greater than the spending rate plus inflation. Three models of endowment spending are outlined: spending all the endowment's income, determining spending as a percentage of the endowment's market value, or increasing each year's spending by a stated percentage tied to growth in the operating budget or to an inflation index. Also provided are some guidelines for asset allocation, addressing especially development of a documented asset allocation strategy. Finally, some suggestions for portfolio structure, manager selection, and evaluation of the manager's performance are offered. (DB)

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BOARD BASICS

FINANCIAL MATTERS

ENDOWMENT MANAGEMENT

BY WILLIAM T. SPITZ

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Endowment Management

Not long ago, only the nation's most prestigious and wealthiest institutions possessed substantial endowments. "Endowment" suggested perpetual financial independence, guaranteeing elite institutions immunity from changing priorities and the rough and tumble of the market place. Today, however, most public and private colleges and universities have endowments and seek to increase them through long-term asset-management strategies and targeted fund-raising efforts.

Many institutions rely on income from their endowments to enhance existing academic programs or initiate new ones, weather unforeseen short-term financial pressures, improve their facilities, or invest in a host of other institutional improvements—some necessary, some elective. For other institutions, healthy and growing endowments are essential to their financial survival, especially as public and private revenue streams level off, decrease, or dry up.

Yet as income from endowments gains importance in an institution's revenue mix, it still is subject to the peaks and valleys of bull and bear markets. The gains of one fiscal year may evaporate the next with little or no warning. Consequently, endowment management—always an important governance function—has become one of a board's most consequential and strategic duties as it carries out its fiduciary and stewardship responsibilities.

Many college and university trustees believe that a growing endowment simply reflects investment skill either on the part of the institution's financial staff or the external managers the trustees have hired. The fact is, trustees determine whether an endowment is successful by setting sound investment policies and guidelines. As trustees weigh their many investment-policy options, they should seek to balance two related priorities:

(1) to increase the endowment for the institution's future and (2) to establish a prudent spending rate to supplement current budget needs. In some institutions, the board as an entity sets these policies; other boards delegate them to investment committees. In each case, the institution's finance or investment staff play key roles.

Specifically, the long-term health of the endowment relies on an appropriate balance between the institution's spending policy and asset mix and a sound management structure that blends investment styles. The actual selection of securities accounts for a small percentage of the variation in return from one endowment to the next. Yet many board investment committees devote most of their effort to reviewing managers and their holdings while spending comparatively little time on the policy issues they alone can address. Among these "make or break" policy questions are the following:

- What is the purpose of the endowment for the institution? How does the endowment support the institution's mission?
- How can boards maximize return on all assets available for investment?
- How much of the operating budget should be supported by endowment funds?
- When is it more prudent to spend endowment funds? To preserve them?
- Should the entire board make investment decisions, or should it delegate the responsibility to an investment committee?
- If a board retains professional investment managers, what guidelines should it use to monitor and evaluate their performance?

None of these questions is answered easily; most involve difficult tradeoffs. For example, trustees must weigh the risk and return of different types of investments and balance the pressures of spending to meet current needs against the wisdom of building assets for the future. Difficult as such decisions are, however, they form the heart of the trustees' collective responsibility as stewards of the institution.

THE BOARD'S MOST BASIC RESPONSIBILITY IS TO PRESERVE INSTITUTIONAL RESOURCES, INCLUDING THE ENDOWMENT, IN PERPETUITY.

FUNDAMENTAL OBJECTIVES OF AN ENDOWMENT. The board's most basic responsibility is to preserve institutional resources, including the endowment, in perpetuity. While this task seems straightforward enough, interpretations of it vary. In the past, trustees felt obliged to preserve the original value of an endowment fund as well as the absolute amount of income it provided to the institution's operating budget. However, the high-inflation era of the 1970s made it painfully clear to board members that simply preserving the value of a fund was not enough. If an endowment had the same market value at the end of the decade as it did at the start, it actually lost half of its purchasing power.

Today, most trustees seek to maintain "intergenerational equity" or "generational neutrality." In other words, their goal is to ensure future students receive the same level of direct or indirect benefits from the endowment as do current students. The size of the endowment and the annual transfer of its yield to the operating budget must keep pace with inflation over time.

This imperative to maintain the real value of the fund leads to a specific investment objective: *The endowment must earn a total return equal to or greater than the spending rate plus inflation.* In other words, the sustainable spending rate—the money transferred to the institutional budget—must be no more than the real or after-inflation return on the fund.

The real return on an endowment largely depends on its asset mix; spending rates are intertwined with asset allocation. Typically, trustees select a target spending rate, which then suggests an appropriate asset mix. Alternatively, they may settle on a "comfortable" asset mix, which then dictates a prudent level of spending. It doesn't really matter which decision comes first. More important is that the two policies are compatible. Only after making these two crucial decisions should board members turn their attention to hiring managers to handle investments.

Endowment Spending. One of a board's most challenging tasks in endowment management is deciding how much of the yield to spend. A spending rate that is too low could deprive current students by shortchanging the operating budget and discouraging necessary—and affordable—institutional improvements. A rate that is too high could jeopardize future students by threatening the core value of the endowment and thus needlessly risking future improvements to the institution.

Spending practices vary greatly among institutions; there is no universally accepted or implemented approach. As a starting point, consider a typical asset mix of 65 percent equities and 35 percent fixed-income securities. Based on historical returns on market indices, such a mix might generate a real return of about 5 percent, which presumably suggests that the board can appropriate 5 percent for spending. However, several factors can chip away at that figure, including the following: (1) the cost of managing the fund, (2) the tendency of institutional investments to perform at a rate lower than market indices, and (3) the inclination of institutional budgets to grow faster than the Consumer Price Index (CPI), the standard measure for the rate of inflation. When all these factors are weighed, trustees should view a 5 percent spending rate as an upper limit, not one they should sustain over time.

After board members have determined a target spending rate, they must work with institutional staff to determine how to transfer those resources to the annual operating budget. Most institutions set a spending formula that delivers the target level of spending over time, a policy that also reduces the temptation to micromanage—say, to increase spending "temporarily" in response to the latest budget crunch. Spending formulas vary widely, but most are based on one of three basic models:

- The traditional approach calls for spending all of the year's endowment income—that is, dividends and interest earned—regardless of fluctuations in the overall value of the endowment fund.

- A second approach focuses on total return, expressing the annual appropriation as a percentage of the endowment's market value. That way, if the endowment decreases in value, spending decreases accordingly, leaving more resources to preserve the endowment's strength.

- The third approach increases prior year spending by a stated percentage, which is tied to growth in the operating budget or to an inflation index such as the Consumer Price Index.

There are advantages and disadvantages to all three models. The income-only and percentage-increase formulas (first and third) provide a stable and predictable stream of revenue to the institution, but they leave the total endowment vulnerable to erosion during a bear market. In contrast, formulas based on market value (the second model) help maintain the stability of the endowment fund, but they potentially wreak havoc on the budget process because the annual transfer can vary so widely.

While most colleges and universities use a spending formula that remains somewhat constant from year to year, there are potential benefits to setting a spending rate that changes annually. Ideally, trustees and administrators together would settle on an annual appropriation after carefully considering such strategic conditions as the institution's overall financial health, fund-raising potential, new program initiatives, and the outlook for capital markets. Not only does this approach provide institutional leaders with greater flexibility, it also enables trustees to become better informed about the institution, especially how investment and spending policies affect its overall condition and strategic direction.

Asset Allocation. In addition to choosing a spending strategy, trustees and the institution's investment staff must select an asset-allocation or asset mix. This decision largely determines the risk and return on the endowment fund; trustees must seek a mix that seems likely to generate the return necessary to sustain the spending rate at a level of risk acceptable to the institution. Board members should focus on long-range *strategic* decisions as opposed to short-term *tactical* asset-allocation decisions, which have only minor effects on the performance of most endowments funds.

The prospect of selecting a target portfolio structure from a seemingly infinite number of options is daunting, especially for trustees who do not make their careers in finance or investments. If board members already have determined a target spending rate, selecting a portfolio structure can be more manageable if they select an overall asset mix that is consistent with that rate. For example, stocks and bonds historically have generated real returns of 7 percent and 2 percent, respectively. By using these assumptions (or other realistic ones) and simple algebra, it is easy to calculate the mix necessary to achieve the target return. Unfortunately, this exercise does not indicate the risk inherent in a given asset mix.

Most endowment funds, however, consist of diverse asset classes. Fortunately, modern technology can help trustees gain some insight into more complex structures. Today, most board members, senior administrators, or consultants have access to optimization and simulation software programs. Optimization programs generate a recommended asset mix and project the return and standard deviation (risk) for the portfolio. Simulation programs do not attempt to recommend an asset mix; they simply display the probable behavior of a suggested asset mix over time. Both approaches can provide projections of endowment value and spending and the range of possible values in good and bad markets.

TODAY, MOST BOARD MEMBERS, SENIOR ADMINISTRATORS, OR CONSULTANTS HAVE ACCESS TO OPTIMIZATION AND SIMULATION SOFTWARE PROGRAMS.

While software programs are useful tools, it is important to understand their limitations. First, optimization and simulation models are driven by forecasts of risk and return for each asset class. The results are *predictions* only; it can be difficult to estimate future rates of return accurately. Second, the programs can indicate the risk inherent in a given portfolio, but they do not determine the level of risk that is appropriate for an institution. Although asset-allocation software programs provide helpful information, they do not absolve trustees from the responsibility of making difficult and complex decisions.

Board members are wise to gather information from as many sources as possible. In addition to reviewing data generated by computer models, trustees also might evaluate the following factors:

- the financial status of the institution,
- asset mixes of similar endowments at peer institutions,
- valuation of various segments of the capital market,
- flow of capital into various asset categories, and
- preferences and biases of trustees and other constituents.

Board members should review the target asset mix regularly in light of changes in the institution's needs and the capital markets. In particular, trustees should be open to new asset classes and willing to consider categories that have performed poorly in recent years. Also, board members may need to rebalance the endowment periodically to return the actual weightings in each asset class to the target level. Some institutions allow the actual exposure to each asset class to fluctuate within a predetermined range on either side of the target weight. Over time, however, disparate returns among investments likely will cause the asset mix to drift toward higher levels of equity exposure—and higher levels of risk.

Further, board members should maintain "asset-allocation discipline," a strategy described by William F. Massy in *Endowment: Perspectives, Policies & Management* (AGB, 1990) as an "explainable reason for adopting a particular set of long-term, asset-allocation targets." Massy says developing a documented asset-allocation strategy gives a board three advantages:

1. It enables board members and institutional investment officers to make better decisions, minimizes inconsistent assumptions about asset allocations, and can protect the board and the institution from legal challenges if losses occur.

2. It ensures trustees share the same knowledge and insight about this crucial policy.

3. It provides insurance against hasty decision making when market situations turn for the worse.

The board must ensure the institution's investment staff develops a strategic view for the portfolio and documents it clearly and coherently. The board as a whole or its investment committee may clarify this strategic view and challenge its assumptions, but the board ultimately is responsible for the soundness of the strategy.

A well-documented and thoroughly debated strategy also will prevent key institutional leaders from making ad-hoc decisions—especially ill-considered actions aimed at counteracting short-lived crises or pursuing opportunities incautiously. All the same, the written strategy should not prevent an institution from taking advantage of emerging opportunities. Rather, it should identify in advance the guidelines and limitations for doing so.

Portfolio Structure and Manager Selection. Once the board or its investment committee has set asset-allocation and spending-rate policies, it next must turn its attention to hiring investment advisers to manage the portfolio. This effort is more likely to succeed if the board already has a well-designed portfolio structure. Money managers are plentiful, and each has his or her own specialties. Therefore, the search for a money manager easily can become unwieldy unless board members focus on finding a manager to fulfill a specific role or assignment within the portfolio.

As with other endowment-management decisions, there are many ways to structure a portfolio. No single approach is best for all endowments or institutions. In the past, a board would hire one or two "all purpose" or "balanced" managers to handle the endowment. As trustees began to assume greater responsibility for asset-allocation decisions, many boards began hiring managers to fill increasingly specialized roles within the equity portion or fixed-income portion of the fund. One such approach calls for hiring managers with complementary investment styles, with the notion that they would balance one another and thus strengthen the stability of the total portfolio. For example, a board might split the small-capitalization stock segment of the portfolio between managers with growth and value philosophies. In another approach, a highly diversified fund—frequently an index fund—forms the core of the portfolio, surrounded by focused "satellite" managers. While these traditional structures remain popular, some funds today are taking yet another approach: selecting large, multiple-product managers to handle several different asset classes within their portfolios.

Many articles and books describe the process of selecting managers in greater depth than is appropriate for this overview of general responsibilities. Even so, the following selection criteria are standard:

- The firm should consist of a stable group of experienced investment professionals whose overarching goal is to accomplish their clients' objectives.

- The firm's investment philosophy should be logical, well articulated, consistent with the institution's investment philosophy, and suitable to the needs of the endowment.

- The firm's processes and operations should be disciplined and orderly.
- The firm's long-term performance record should be sufficiently positive as to prove the foregoing criteria.

This last statement directly contradicts the common practice and conventional wisdom of selecting managers primarily on the basis of their superior returns for recent investments (five years or fewer, for example). Generally, such short-term performance results from the normal ebb and flow of investment styles; luck also plays a role. Studies have shown that manager returns over a five-year period have almost no predictive value regarding future results.

Manager selection is the step in the investment process at which a board most likely confronts potential conflicts of interest. Investment committees often are composed of bankers, investment advisers, and other financial executives who might have a stake in the outcome of a manager search. Some institutions address this problem by establishing policies that forbid any firm with a direct tie to a trustee from competing for the institution's endowment business. Other institutions implement policies that require trustees to disclose any potential conflicts to the institution's chief executive and other board members. Regardless of the specific policy an institution adopts, it must be written, and every board member must agree to abide by it.

Performance Evaluation. Modern investment technologies enable trustees to analyze the sources of a manager's return and to determine whether individual investment decisions truly add value to the portfolio. But these helpful technologies are not the sole measure of a manager's success. Rather, trustees should approach the process of performance evaluation with two principles in mind.

1. Boards should measure a manager's performance against a benchmark that is appropriate to the firm's investment style. Once again, this point emphasizes the need for the board to develop a rational portfolio structure and to select managers who fill carefully specified roles within it.

2. Boards should avoid judging a manager's skills on the basis of short-term results. Firing an otherwise successful manager following a period of poor performance generally is counterproductive. Style, timing, and luck play prominent roles in short-term results, and as much as 20 years of data may be required to demonstrate statistically that a manager has not added value to a portfolio. Further, the cost of switching managers can be very high, particularly in the case of small-capitalization stocks or other less marketable securities.

When *should* a board replace a manager? A change in an institution's investment approach or a manager's violation of investment guidelines unquestionably are grounds for immediate dismissal. Also, when key personnel—including principals—change at the investment firm, board members should call for an intensive review of the firm and its remaining investment professionals. Additionally, trustees may want to consider a change following a meaningful period of poor returns as compared with relevant benchmarks.

CONCLUSION. Historic and recent events underscore the importance of trustees' vigilance in setting and overseeing endowment policies and investments. While it is necessary—even desirable—for trustees to rely on professional expertise from institutional staff or consultants, only the board bears fiduciary responsibility. It alone is responsible for all aspects of the endowment.

As higher education institutions experience some degree of financial vulnerability that will continue for the foreseeable future, they increasingly will depend on income from their endowment funds for budget support. To sustain this present need while protecting the institution's future, board members must call for and oversee an organized, disciplined approach to endowment management that is firmly grounded in strategic goals. This approach does not guarantee success, but a laissez-faire method to endowment management or hasty decisions that send investments ricocheting among short-term options are prescriptions for disaster.

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This publication is part of **Board Basics**, an AGB series devoted to strengthening the effectiveness of governing boards and trustees. Board Basics comprises several topic clusters—The Fundamentals, Financial Matters, Fund-Raising, Academic Affairs, Leadership, Strategic Decision Making, and Effective Committees—each of which contains several booklets. Several assumptions underlie the series:

- Academic trusteeship grows increasingly ambiguous, and trustees need concise, accessible, and focused information to help them carry out their complex fiduciary and stewardship responsibilities.
- Basic principles of trusteeship remain constant across higher education, regardless of institutional type, size, and mission. The series highlights these general principles to provide trustees with a core of knowledge they can apply to their individual institutions.
- The series addresses the distinguishing characteristics of academic trusteeship, especially as it differs in scope, substance, and focus from corporate directorships and other board service.

AGB and the authors welcome comments and suggestions to improve this publication and others in the series. Call AGB publications at 800/356-6317 or visit our Web site at http://www.agb.org for more information.

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